

1-1955

## Contracts in Favor of Third Parties

Merton Ferson

Follow this and additional works at: [https://repository.uchastings.edu/hastings\\_law\\_journal](https://repository.uchastings.edu/hastings_law_journal)



Part of the [Law Commons](#)

---

### Recommended Citation

Merton Ferson, *Contracts in Favor of Third Parties*, 6 HASTINGS L.J. 354 (1955).

Available at: [https://repository.uchastings.edu/hastings\\_law\\_journal/vol6/iss3/3](https://repository.uchastings.edu/hastings_law_journal/vol6/iss3/3)

This Article is brought to you for free and open access by the Law Journals at UC Hastings Scholarship Repository. It has been accepted for inclusion in Hastings Law Journal by an authorized editor of UC Hastings Scholarship Repository.

# CONTRACTS IN FAVOR OF THIRD PARTIES

By MERTON FERNON\*

## *Introduction*

The law with regard to simple contracts has been plagued for centuries by a contest between fiction and reality. Particularly, that contest has unsettled the law with regard to contracts in favor of third parties. The fiction is that the promisor-obligor has cheated the promisee-obligee out of something and, for that reason, should be held liable. The reality is that the promisor-obligor has consented that he shall be bound to a designated obligee and, for that reason, he should be held liable. It may seem, at first blush, that there is liability under either the fiction or the reality, so, why quibble about the theory on which recovery is had. It will, however, appear presently that important and divergent implications attend the respective theories and, in some cases, point to opposite decisions. Let us note where the fiction came from and what are some of its implications.

## *The Fiction: Its Implications*

It should be recalled that in the fifteenth century, when simple contracts first appeared in the courts, a plaintiff had to fit his case into a mould, called a form of action. The form of action was like a procrustean bed. If the facts of the plaintiff's case did not fit the chosen form of action he had to change the facts until they would fit. It should be noted, too, that there was no form of action wherein a plaintiff could recover by simply stating and proving that the defendant made a promise which he failed to perform. It did seem that the promisee should, as a matter of justice, be able to recover. There was a form of action that the plaintiff could use if he had been deceived, viz., trespass on the case. And so what was factually only a simple promise followed by default, was warped into a deceit. The deceit was fictional.

The fiction was invented to meet a supposed necessity that the facts of a case must make out a deceit in order that the plaintiff could recover on a broken promise.

Let us first suppose a case of genuine deceit arising in the early part of the fifteenth century. Assume that Skinner, a craft person, coveted Cornwall's horse, Pompey. Cornwall was reluctant to part with Pompey unless he should receive the price immediately in exchange for the horse. But Skinner, pursuing an evil design that he would never pay for the horse, said, "Mr. Cornwall, let me have Pompey now and I promise to pay you, come

---

\* Professor of Law, Vanderbilt University; Dean Emeritus, University of Cincinnati College of Law; author, *THE RATIONAL BASIS OF CONTRACTS* (1949), *PRINCIPLES OF AGENCY* (1954).

next January first." Skinner thus used a promise to accomplish his wicked purpose — to wheedle Cornwall into giving up the horse.

Suppose further that, when January first came around, Cornwall demanded payment but found that Skinner had shed his sincere manner. He utterly refused to pay and defied the demand of Cornwall. These facts, added together, make out a case of deceit. Skinner has cheated Cornwall out of a horse. An action of trespass on the case on the promises would be available to Cornwall.

Next suppose that, at about the same period, an honest man bought a horse and gave in exchange his solemn promise to pay for it. He fully intended, for all that appears, to perform his promise. But when the promise fell due it was not performed. Such facts do not make out that any real deceit was practiced on the seller, although the buyer made a promise and later omitted to perform it. What could the seller do? He could sue in debt. But that form of action, wherein the buyer could wage his law, was unsatisfactory. The rising sense of justice demanded that the plaintiff should have a more effective remedy. Some ingenuity was required. A loose interpretation of what the judges and lawyers of the period did is this: They put their heads together and said, "Let's pretend that everyone who breaks a promise that was made in the procurement of something has committed a deceit." Accordingly, the making and breaking of a promise was deemed a deceit, however honestly the defendant may have acted.<sup>1</sup> The plaintiff's statement of his case included such language as this: "Yet the said C.D., not regarding his said promise, but contriving and fraudulently intending, craftily and subtly, to deceive and defraud the plaintiff," etc.<sup>2</sup> omitted to perform. This fiction, that the promisor had committed a deceit, was necessary in order that the plaintiff might sue in trespass on the case.

Two implications attend when simple contracts are put on this fictional basis. They should be particularly noted. First, in order to satisfy the fiction, the promise must be made to the plaintiff. Else, how could it induce him? Second, the plaintiff must have given up something. Else, how was he injured? The fiction, with its corollaries, has persisted long after forms of actions have gone into the limbo. And it has hindered the establishment of contracts on a rational basis.

### ***Legal Transactions: Based on Consent of Parties Bound***

Through the centuries there have been legal transactions. They are the essence of commerce and are the means whereby every normal adult can bargain away what he has for what he wants. Legal transactions are the

<sup>1</sup> 3 HOLDSWORTH, A HISTORY OF ENGLISH LAW 429 *et seq.* (3d ed. 1923), Ames, *The History of Assumpsit*, 2 HARV. L. REV. 1 (1888).

<sup>2</sup> AMES, *supra* note 7, at 16.

genus of which simple contracts should be deemed a species. Let us notice their forms and the philosophy that is implicit in their long and extensive use. Mention will be made of some familiar kinds of legal transactions, ancient and modern. It will be seen that, while they vary in form, their vital element is constant.

Livery of seisin was an ancient ceremony whereby the feoffer voluntarily transferred his ownership of real property to another.<sup>3</sup> The execution and delivery of a sealed instrument is a voluntary formality, that has been in use for centuries, whereby the party who executes the instrument conveys a title or assumes an obligation.<sup>4</sup> Bills of exchange in ancient<sup>5</sup> as well as modern use, bind the persons who voluntarily sign and issue them. Declarations voluntarily made by the owner of property that he holds the property in trust for another are binding on him. Wills that were voluntarily made, in due form, are given effect to transfer property that belonged to the testator. Gifts of chattels voluntarily made and accompanied by delivery are binding on the donor. Such transactions have increased in modern times to an incredible volume. They include transactions both large and small, both unilateral and bilateral. They include, for instance, the purchase and sale of a newspaper for a few cents; the purchase and sale of a locomotive or a diamond or a skyscraper for a million dollars; a service contract to have one's shoes shined for a quarter; the creation of a complicated trust arrangement, by will or inter vivos; and, the taking on of special duties as a carrier, bailee, or innkeeper.

The idea basic in all legal transactions is that a normal person can, by his enacted will, divest himself of rights, privileges, and other legal advantages.<sup>6</sup> He can, if he wants to, derogate from his legal position. Stated in more familiar terms, persons have for centuries transferred their property and bound themselves in obligations by their acts of consent. Such acts have been called "juristic acts" to distinguish them from other acts.<sup>7</sup>

Simple contracts are genetically like other legal transactions. They take it for granted that: (1) a person can be obligated (bound) to do this or

<sup>3</sup> 2 BL. COMM. 315.

<sup>4</sup> *Id.* at 297 *et seq.* The ancient Hebrews used another form. "Now this was the custom in former times in Israel concerning redeeming and exchanging to confirm a transaction, the one drew off his sandal and gave it to the other, and this was the manner of attesting in Israel." *Ruth*, IV, 7 (Revised Standard Version 1953).

<sup>5</sup> BRANNAN, *NEGOTIABLE INSTRUMENTS LAW* 4 (7th ed., Beutel, 1948), BRITTON, *BILLS AND NOTES* 2 (1943), Bosanquet, *The Law Merchant and Transferable Debentures*, 15 L.Q. REV. 130, 138 (1899).

<sup>6</sup> HOLLAND, *ELEMENTS OF JURISPRUDENCE* 117 (13th ed. 1924), MARBLEY, *ELEMENTS OF LAW* 125 (6th ed. 1905), POLLOCK, *A FIRST BOOK IN JURISPRUDENCE* 142 (2d ed. 1896), SALMOND, *JURISPRUDENCE* 481 (9th ed., Parker, 1937).

<sup>7</sup> For a more extended definition of "juristic acts" see FERSON, *BASIS OF CONTRACTS* 60 *et seq.*

that, and, (2) he can become so obligated by the enactment of his will. Why pause to state propositions that are so obvious? They are simple and clear. They are confirmed in the vast commerce that goes on daily. They are fortified by countless decisions. But it was not always so. Obligations were seen but dimly in the fifteenth century when plaintiffs first sued on broken promises. Primitive men bartered their chattels. But the idea of obligations, so familiar to us, was a late development in the progress of thought. To be sure the ancient action of Debt contained the nascent idea of obligation. But that action was brought on the theory that the defendant detained something that belonged to the plaintiff. And the action itself fell into disuse before it was seen in its true light, viz., an action on an obligation owing by the defendant to the plaintiff.

### *Double Background*

Simple contracts came into the common law against this double background. On one hand such contracts had to be twisted into deceptions for procedural reasons. On the other hand a variety of legal transactions gave every normal adult person power to divest himself of property or to bind himself in obligations by suitable voluntary acts.

The idea of obligation, and that it can be created by a voluntary act of the obligor has these implications: the obligor can at will fix the time, place and character of the performance to be rendered. And, of especial importance in third party contracts, he can indicate to whom his performance is owing.

### *Two Theories Clash: In re Contracts in Favor of Third Parties*

The opposition of the deceit theory of contracts to the juristic act theory is implicitly in the long struggle that occurred before contracts made in favor of third parties were upheld. The consideration requirement and the privity requirement are both corollaries of the deceit theory. On the deceit theory a plaintiff, in order to recover, must satisfy both of these requirements. He cannot have been deceived and cheated if he gave nothing by reason of the promise. And that is so, *a fortiori*, if the promise did not even come to him.

But if the plaintiff's case is bottomed on the defendant's undertaking, as a legal transaction, the plaintiff does not claim to have been cheated. He depends on the defendant's juristic act of consenting that he should be bound unto the plaintiff. Questions about privity, and as to who suffered the consideration, are beside the point.

Suits by third party beneficiaries, therefore, test the theory that underlies simple contracts. Does the plaintiff, suing on a simple contract, seek to

recover on the fictional deceit basis that would have supported him in the fifteenth century? Or does he seek to recover on the simple and rational basis that supports a plaintiff suing on a legal transaction in our day? In a suit brought by a third party beneficiary, the result reached under the deceit theory of contracts would be exactly opposite to the result that would be reached under the juristic act theory. The deceit theory would lead to no recovery. The juristic act theory would lead to recovery.

### *Simple Statement of the Problem*

In order to pose the problem as simply as may be, we may suppose that A promised B to pay C. That is, as part of a bargain between A and B, A undertook to be bound in an obligation to C. It may be further supposed that C gave no consideration and that he was not aware of the bargain when it was made. Can C recover against A or A's undertaking? If the history of the way contracts came to be enforced could be brushed aside and a candid view taken of the facts, the answer would be simple. As should be held according to the tenor of his undertaking. And indeed that result is ultimately reached in almost all American jurisdictions. We shall restate that result and the simple reason for it later. But, in the meantime, it is necessary to consider the labored and irrational processes that have been used to reach that result. It is sufficient for a layman to know that generally a third party can recover on a contract that was made in his favor. But a lawyer cannot afford to be so superficial as to brush judicial history aside and ignore the reasoning by which a given doctrine came to be established.

### *Consideration: Privity*

Although the courts of both England and America wanted to help the third party in whose favor a contract had been made, there were two reasons why he should not recover. First, he did not give the consideration. He was not cheated out of anything. Second, the promise was not addressed to him. He was not privy to the transaction. There is no doubt as to what is meant by the term "consideration." The term "privity" however has been misunderstood although its meaning is simple.

Courts have frequently taken it for granted that there must be "privity" between the parties in order to create a contract obligation. But the courts have not told us what the word "privity" means. Its meaning must be made out from the context in which the word is used.

"A sort of mystery," says Professor Corbin, "accompanies many of our words." He then indicates that "privity" is such a word.<sup>8</sup> The mystery deepens when we note that the word "privity" is used in two distinct con-

<sup>8</sup> 4 CORBIN, CONTRACTS 28 (1951).

nections and that it has meanings that are necessarily different in the respective connections. In one connection it has to do with the ownership of property. In the other connection it has to do with an operative fact in the making of a contract.

In the field of property, the word "privity" has a well settled meaning. It is this: "Mutual or successive relationship to the same rights of property . . . Thus, the executor is in privity with the testator, the heir with the ancestor, the assignee with the assignor, the donee with the donor, and the lessee with the lessor."<sup>9</sup>

"Privity" as an operative fact in the making of a contract obligation is altogether different from privity of estate — as described in the preceding paragraph. When regard is had for such authority as is available, the mysterious word, "privity," stands for a very simple fact. It is this: communication by the promisor to the promisee. And so, if privity should be required in order to create an obligation by promising, it would be needful that the promisor should do two things — enact his consent to be bound, and get notice of his act to the potential obligee.

That privity means simply communication by the promisor to the promisee can be made out from the context in a good many cases. Note, for instance, the case of *Marston v. Bigelow*,<sup>10</sup> where Morton, C. J., says, "In the case at bar there was no offer to prove a promise to the defendant . . . there was no privity of contract between the plaintiff's intestate and the defendant." Note, too, the dissenting opinion of Comstock, J., in *Lawrence v. Fox*.<sup>11</sup> He says, "In general, there must be privity of contract. The party who sues upon a promise must be the promisee . . ." The foregoing quotations are not accurate statements of the law. They are put in to indicate what "privity" means.

Should privity be required in the making of a contract? If so, why? That forces the question: Why is recovery allowed when one breaks a simple contract? What is the theoretical basis for such a recovery? Two possible bases for recovery on a simple contract have been noted. One is a fiction to the effect that the plaintiff has been cheated by the promisor. The other is that the promisor enacted his consent that he should be bound in an obligation and thus created an obligation. If the plaintiff hopes to recover on the fiction that he has been cheated, it is an essential part of his case to show that the promise came to him and moved him to give up something. Privity is a *sine qua non* if the plaintiff must make out a case of trespass on the case as he had to do in the fifteenth century. But this is another day. Forms of

<sup>9</sup> BLACK, LAW DICTIONARY 1361 (4th ed. 1951).

<sup>10</sup> 150 Mass. 45, 53 (1889).

<sup>11</sup> 20 N.Y. 268 (1859).

action have been abandoned. Courts no longer require that a plaintiff must make out trespass on the case in order to recover on a broken contract.

When the making of contract obligations are assimilated with other legal transactions the need for privity disappears. The vital factor in all such transactions is that the transferor, obligor or other person who gave up legal advantage shall have consented to be bound according to the terms of the transaction. Privity is not generally required in the making of legal transactions. Property can be transferred to a person who has not been notified of the transfer.<sup>12</sup> Declarations of trust are effective without notice to the beneficiary.<sup>13</sup> The appointment of an agent can be effective before communication of the appointment has come to the appointee.<sup>14</sup> An obligation can be created by deed without communication to the obligee.<sup>15</sup> Analogies drawn from other kinds of legal transactions indicate that privity should not be necessary in the making of simple contracts.

### *Digression: Bailment for a Third Party*

Before studying further the rights of third persons to recover on contracts that have been made in their favor a digression is in order. We should note, and set aside, two kinds of transactions that, in one aspect, are like contracts that were made in favor of third persons, and yet are altogether different from such contracts. One such transaction is this: the owner of property may deliver it to a bailee with an understanding between him and the bailee that title to the property is being passed to a third party. A common illustration of such transactions is shipments of property under such circumstances that title passes to the consignees. The law is settled that the bailee in such cases (the carrier in the illustration put) is bound to the new owner. Action can be maintained by the new owner against the bailee in case the property is lost or damaged owing to the bailee's fault. The rigor and extent of the bailee's liability depends on circumstances. The point being made is that the bailee is liable to the new owner without regard to whether the new owner gave consideration or was privy to the transaction.

### *Trust Set Up for Third Person*

A second kind of transaction is to be noted and set aside is this: the owner of property conveys it to another who consents that he shall be bound

<sup>12</sup> *Moore v. Trott*, 162 Cal. 268, 122 Pac. 462 (1912), *Port Huron Machinery Co. v. Wohl-ers*, 207 Iowa 826, 221 N.W. 843 (1928), *Wheat v. Cross*, 31 Md. 99 (1869), *In re Tardibone's Estate*, 196 Misc. 738, 94 N.Y.S. 2d 724 (Surr. Ct. 1949), *Taylor v. Sanford*, 108 Tex. 340, 193 S.W. 661 (1917).

<sup>13</sup> *In re Prudence Co.*, 24 F. Supp. 666 (E.D.N.Y. 1938), *Ex parte Pye*, 18 Ves. 140, 34 Eng. Rep. 271 (Ch. 1811).

<sup>14</sup> *Ruggles v. American Cent. Ins. Co.*, 114 N.Y. 415, 21 N.E. 1000 (1889).

<sup>15</sup> *Butler and Baker's Case*, 3 Co. Rep. 25a, 26b, 76 Eng. Rep. 684, 689 (K.B. 1591).



as trustee of the property in favor of a third person. In this kind of transaction, also, the law is well settled that the trustee is bound to the third party (beneficiary), although the third party gave no consideration and is not privy to the transaction. The third person's right, in trust cases, is sometimes described as a "right *in personam ad rem*." He is more commonly said to be the equitable owner of the thing that is held in trust. At any rate the beneficiary (third party in the case put above) has recourse in the equity courts against the trustee in case the latter shall dissipate the property or fail to account to the beneficiary. Trusts, being an invention of the equity courts, had a history different from contracts, which were developed mainly in the law courts. The equity courts were not deterred by the absence of privity or consideration when it seemed that a trustee should be held bound. The two kinds of transactions, described above, whereby third persons are made the legal or equitable owners of property, should be clearly distinguished from the subject of this essay—viz., plain contracts that are made in favor of third persons.

### *Judicial Instinct In Re Third Parties*

Courts in both England and America have shown a desire to uphold third party beneficiaries. But they have been baffled, to an extent, by the ancient requirements that a plaintiff, in order to recover on a broken promise, must show that the promise came to him and that it induced him to give up something. Said Lord Dunedin, in *Dunlop Pneumatic Tyre Co., Ltd. v. Selfridge & Co., Ltd.*<sup>16</sup>

"My Lords, I confess that this case is to my mind apt to nip any budding affection which one might have had for the doctrine of consideration; for the effect of that doctrine in the present case is to make it possible for a person to snap his fingers at a bargain deliberately made, a bargain not in itself unfair, and which the person seeking to enforce it has a legitimate interest to enforce." The disposition of American courts to favor third parties appears in the host of decisions that have been rendered in favor of third parties on one pretext or another.<sup>17</sup>

### *English Decisions: Pretended Trust*

The English common law courts have held flatly that a third party cannot recover on a contract that was made in his favor.<sup>18</sup> But the third party is not utterly without a remedy in England. The courts, feeling that justice was on the side of the third party, found a way to help him. The scheme

<sup>16</sup> (1915) A.C. 847.

<sup>17</sup> CORBIN ON CONTRACTS § 772 (1951).

<sup>18</sup> *Bourne v. Mason*, 1 Ventris 6 (1669), *Tweedle v. Atkinson* Executor of Guy, deceased, 1 Best & Smith 393 (1861), *Dunlop Pneumatic Tyre Co., Ltd. v. Selfridge & Co., Ltd.* *supra*.

that is used to help the third party was resorted to in *Tomlinson v Gill*,<sup>19</sup> an early case in the Equity Court. The salient fact in that case was that the defendant promised the widow of a deceased person to pay debts of the deceased. The creditors of the deceased brought a bill to get performance of that promise. The court decreed that the defendant must pay according to his promise. Even though the promise was in terms a promise to the widow, which could not be enforced by third persons, the court pretended that the parties had set up a trust in favor of the third persons (creditors), which could be enforced. How could the facts in that case be warped into a trust? Particularly, who was the trustee? And what thing was held in trust? It will be observed that the defendant (promisor) held nothing in trust for the creditors. His promise was to pay from his own pocket. It was the conception of the court that the widow (promisee) was the trustee, and that the thing she held in trust was a claim against the defendant. By treating the transaction as a trust the court relieved the third parties (creditors) from meeting the requirements of consideration and privity, which would have beset them if they had been deemed to be suing on a straight contractual promise.

This trust device that was used by English courts to help out third parties will not stand critical analysis. In the first place it warps the intentions of the parties to say that they intended to create a trust. And in the second place the claim, that the promisee (trustee) is said to hold in trust, is not a claim that the trustee shall be paid. It is an alleged claim that the third person shall be paid. And to assert that there is such a valid claim is begging the question. The issue is whether such a claim exists, and, if it does, there is no need for the trust. At any rate, the device has been used in England from time to time and has afforded a remedy whereby third parties were able to recover what was justly their due.<sup>20</sup> Maybe the end justifies the means.

### *American Decisions: What Price Privity*

It has already been noted that the American courts have been disposed to favor third parties in whose favor contracts have been made. In such cases the courts were, of course, faced with the fact that the third-party-plaintiff gave no consideration for the promise he sought to enforce. That proved to be only a small obstacle. While there had to be consideration, it was generally held that someone other than the plaintiff could furnish the consideration.<sup>21</sup> The consideration furnished by the promisee was, therefore, sufficient. But privity! That was the rub. A good many of the early

<sup>19</sup> Ambler 330. 27 English Reports 221 (1756).

<sup>20</sup> *Les Affréteurs Réunis Société Anonyme v Leopold Walford, Ltd.* (1919) A.C. 801. *Lloyd's v. Harper*, 16 Ch. Div. 290 (1880).

<sup>21</sup> *Farley v Cleveland*, 4 Cow. 432 (1825), same case in error, 9 Cow. 639 (1827).

decisions, perhaps a majority, were to the effect that a third party beneficiary could not recover. In course of time various processes of reasoning were used to get around the fancied need for privity. Among such processes were these three: One method was to assume as a fact that the promisee was agent for the third party. A second method was to subrogate the third party to the right of the promisee against the promisor. And a third method was to put the cart before the horse like this: The third party can recover. That proves there was privity. These processes of reasoning, so obviously specious, would seem to call for no further comment. But each one has been resorted to at times and so they will be further discussed *seriatim*.

### ***Creditor Beneficiaries***

Before examining in detail the reasoning of the American courts a distinction should be noted between two types of cases—viz., the “creditor-beneficiary” type and the “donee-beneficiary” type. The difference is a difference in the motives of the promisees in the respective types. The creditor-beneficiary type of case stems from a purpose on the part of the promisee to get his debt paid—a debt that was owing from the promisee to the third person. The famous case of *Lawrence v. Fox*<sup>22</sup> will serve to illustrate the creditor-beneficiary type. The background of that case was that Holly owed Lawrence. Holly went about getting himself absolved by making a bargain with Fox. The bargain was this: Holly paid three hundred dollars to Fox and Fox promised Holly to pay a like amount of money to Lawrence. Lawrence is the third party, whom Fox agreed to pay, and, since the bargain was made to procure payment of an antecedent debt that was owed to him by Holly, Lawrence is branded as a creditor-beneficiary.

### ***Donee Beneficiaries***

In the donee-beneficiary type of case there is no debt in the background owing from the promisee to the promisor. In such cases the motive of the promisee is commonly charitable. At any rate he does not procure the promise by way of getting his own debt paid. Consider, for example, the case of *Pruitt v. Pruitt*.<sup>23</sup> In that case it appeared that Nancy Pruitt had two sons and a mother's instinctive desire to help them. To this end she conveyed land to her son Alexander, who promised his mother that he would pay a sum of money to his brother Joseph. Note that, in this case, there was no obligation in the background running from the mother, Nancy, to her son Joseph. This fact brands Joseph as a donee-beneficiary. In both of the cases just cited and contrasted the third party beneficiaries were allowed to recover. But, in a good many third party cases, differing decisions were

<sup>22</sup> 20 N.Y. 268 (1859).

<sup>23</sup> 91 Ind. 595 (1883).

reached according to whether the third party was a creditor-beneficiary or a donee-beneficiary. The rationalization of one court may lead it to prefer a creditor-beneficiary, while the rationalization of another court may lead it to prefer a donee-beneficiary. This will appear as we discuss the respective theories that courts have resorted to in the third party cases.

### *Agency of Promisee*

In the quest for privity, courts have sometimes assumed that the promisee was agent for the third party.<sup>24</sup> It was further assumed that a promise made to the agent was virtually made to the principal (third party). The idea is made of whole cloth. Factually the promisee, in making the deal, was promoting his own interests or desires, such as getting his own debts paid or providing for a relative. Moreover the promisee generally has no authority to bind the third person in any obligation or to any transfer of his property. The sham agency has nothing to commend it except that it leads to a desired result. Insofar as the fictional agency theory is indulged it would seem to favor the creditor-beneficiary and the donee-beneficiary alike.

### *Subrogation: Alias the Asset Theory*

This theory is vaguely defined but has been extensively used by American courts. It presupposes that the third party has a claim against the promisee on which he could recover a judgment. Against this background, the promisor undertakes to pay what the promisee owes to the third person. Now, if the third party were to reduce his claim against the promisee to judgment, his next step would be to levy on the assets of his promisee-debtor. The undertaking of the promisor to pay the debt of the promisee is an asset in the sense that payment of the debt would relieve the promisee to that extent and enhance his estate by that much. In this situation, a recovery by the third person against the promisor is a short cut whereby he gets the advantage that would be his if he were to get a judgment against the promisee-debtor and then realize on this particular asset.

It will be observed at once that the asset theory gives no aid to the donee-beneficiary. The third party's right according to this theory is derivative through the promisee. If the third party had no right against the promisee he cannot get to first base.

The asset theory has been intimated rather than stated in a good many leading cases. In *Lawrence v Fox*,<sup>25</sup> for instance, it was argued by the defendant that the evidence of a by-stander was not admissible to prove that Holly owed Lawrence. The court held that the evidence was admissible and

<sup>24</sup> *Gardner v. Denison*, 217 Mass. 492, 105 N.E. 359 (1914), *Lawrence v Fox*, 20 N.Y. 268 (1859) (Agency relied on by Johnson, C.J. and Denio, J.).

<sup>25</sup> 20 N.Y. 268 (1859).

adequate. But what is the difference whether Holly owed Lawrence or not? The suit was not against Holly. The point of the argument was that Holly's indebtedness to Lawrence was essential in order to make out the case of Lawrence against Fox. In other words, the intimation of the argument and the court's opinion is that the third party can recover only if he is a creditor-beneficiary. The later case of *Durnherr v. Ray*<sup>26</sup> confirmed that idea and made it explicit. And in a good many other jurisdictions, as well as in New York, it was, for a long time, the accepted rule that a creditor-beneficiary could recover on a promise that was made in his favor, but that a donee-beneficiary could not recover.

### *Grantee Promises Grantor to Pay Mortgage Debt*

The distinction between creditor-beneficiaries and donee-beneficiaries and their respective rights has been made in many cases where the grantees of property promised their grantors to pay off mortgage debts that stood against the property. In many cases, a grantee merely receives the property subject to the mortgage. In such cases the grantee stands to lose the property if the debt is not paid, but he is not subject to personal obligation. But suppose that the grantee assumes—i.e. promises his grantor that he (the grantee)—will pay the debt. The creditor-mortgagee, in such a case, becomes a third party beneficiary. Such arrangements for getting the debt paid are common incidents of land transfers. And a host of cases have dealt with the legal effect of such contracts.<sup>27</sup>

In simple cases, such as the one supposed in the preceding paragraph, where the promisee-grantor owed the mortgagee-third party, the mortgagee is generally allowed to recover. Such a case is of the creditor-beneficiary type. Recovery can be justified by the "asset" theory. But suppose a case like this: There has been a succession of transfers. One of the grantees did not undertake to pay the debt. He merely took the property subject to the mortgage. A later grantee promises his grantor to pay the debt that was owing by a former owner to the mortgagee. A good many such cases have arisen and there is a difference of authority as to whether the mortgagee-creditor can recover against the late grantee who promised to pay. Analysis reveals that the basic question is whether a donee beneficiary can recover. The promisee was not owing the mortgagee. In such a case the third party mortgagee gets no support from the "asset" theory.

<sup>26</sup> 135 N.Y. 219, 32 N.E. 49 (1892).

<sup>27</sup> There is a popular notion that identifies a mortgage with the debt it secures. Students should note and remember that the mortgage and the debt are separate. The mortgage gives the creditor an interest in the debtor's property. The note or other form of indebtedness binds the debtor personally. If a mortgage foreclosure falls short of providing the amount that is due a deficiency judgment can be had against the debtor. And our question, at the moment, is whether such a judgment can be had against another who assumed the debt.

### *The Idea That the Law Creates Privity*

We have noted that the ability of the third party to recover on a contract that was made in his favor is sometimes explained by the agency theory and, sometimes, by the asset theory. A third theory has been used in a few cases. Briefly it is that the law creates the privity. Said Bigelow, J. in *Brewer v. Dyer*,<sup>28</sup> "[T]he law, operating on the act of the parties, creates the duty, establishes the privity, and implies the promise and obligation, on which the action is founded." This passage is quoted with approval in *Lawrence v. Fox*.<sup>29</sup> The proposition that the law operates on the act of the parties is sound. But the proposition that the law creates the promise and the privity is ascribing to the law an effect that it cannot possibly have. The law can, and does, affix obligations on contractors by reason of acts they have done. But the law cannot by *ipse dixit* create privity or any other operative fact.

### *The Restatement of Contracts*

We have discussed the various theories that have been advanced with regard to contracts that were made in favor of third parties. This discussion was in deference to the thousands of pages that have been printed explaining why the third parties could or could not recover. Happily these theories and the need for them are on the way out. The privity requirement, a relic of the action of trespass on the case, is rapidly being put aside. In recent years an increasing number of courts have held that third parties—either creditor-beneficiaries or donee-beneficiaries—could recover on contracts that were made in their favor. The Restatement of the Law of Contracts, issued by the American Law Institutes flatly provides that the promisor incurs a duty to a donee-beneficiary<sup>30</sup> and likewise to a creditor-beneficiary.<sup>31</sup>

### *Modern Basis for Right of Third Party*

In recent cases, and in the Restatement of Contracts, it appears that the quest for privity has been abandoned. The third party therefore does not need any special theory to uphold him. He needs only the general theory that supports all contracts. That theory seems to be this. a contract is a legal transaction and a contractor should be held according to the tenor of his undertaking. This doctrine is simple, rational and in accord with the trend of judicial decisions. This trend is so strong that the law is practi-

<sup>28</sup> 61 Mass. (7 Cush.) 337, 340 (1851).

<sup>29</sup> 20 N.Y. 268, 272 (1859). "[T]he law immediately operates upon the acts of the parties, establishing the essential of privity between the promisor and the third person." *Tweeddale v. Tweeddale*, 116 Wis. 517, 93 N.W. 440 (1903)

<sup>30</sup> § 135.

<sup>31</sup> § 136.

cally settled to the effect that the third party can recover whether he is a creditor-beneficiary or a donee-beneficiary. That basis for the third party's right is implied in many cases, and is expressed in some. In *Byram Lumber & Supply Co. v. Page*,<sup>32</sup> Maltbie, J. said, "[T]he intent which must exist on the part of the parties to the contract in order to permit the third party to sue was not a desire or purpose to confer a particular benefit upon him, but an intent that the promisor should assume a direct obligation to him." In a later passage of his opinion the Judge indicates that it is "an intent to create a direct obligation to the third party" that counts, rather than "a desire to advance his interests." And said Judge Draper in *Jackman Cigar Mfg. Co. v. John Berger & Son Co.*,<sup>33</sup> "[T]he 'intent' which is necessary to the third party's right to sue is 'not a desire or purpose to confer a particular benefit upon him,' nor a desire to advance his interests or promote his welfare, but an intent that the promising party or parties shall assume a direct obligation to him."

### *Conveyance and Contract Compared*

Let us spell out two familiar transactions—viz., a sale or gift of property and the making of a contract obligation. The one and the other is accomplished by the same kind of an act. It is a consenting by the transferor or promisor, as the case may be, that he shall be bound—in one case to the divestment of his property, and, in the other, to an obligation. Another point of likeness between the making of a conveyance and the making of an obligation is this: The one and the other invariably runs to some definite person or persons. That is a term in the transaction and it is the transferor or contractor who dictates the terms, including a designation of who shall be the beneficiary. In the case of a contract made in favor of a third person an undertaking commonly runs to the promisee. But, consistently with that, the promisor may also contemplate and bind himself to a third party. It is a question of interpretation as to whether he has done so. The conveyance and the contract forms of transactions have also come to be alike with regard to privity—i.e., it is no longer necessary for the

<sup>32</sup> 109 Conn. 856, 146 A. 293 (1929).

<sup>33</sup> 114 Ind. App. 437, 52 N.E.2d 363 (1944). See also *Mackubin v. Curtiss-Wright Corporation*, 190 Md. 52, 57 A.2d 318, 321 (1948), where Judge Delaplane made this statement: "In order to recover it is essential that the beneficiary shall be the real promisee—i.e., that the promise (undertaking) shall be made to him in fact, though not in form." This statement is quoted with approval in *Marlboro Shirt Co., Inc. v. American Dist. Tel. Co.*, 196 Md. 565, 77 A.2d 776 (1951).

And in *Moch Co., Inc. v. Rensselaer Water Co.*, Cardozo, J. had this to say: "It (the benefit) must be primary and immediate in such a sense and to such a degree as to bespeak the assumption of a duty to make reparation directly to the individual members of the public if the benefit is lost." (Emphasis added.)

transferor or the contractor to communicate what he has done to the beneficiary

*"For the Benefit Of:" An Inapt Phrase*

Does the mere fact that a person would benefit from the performance of a contract enable him to sue in case the contract is broken? The answer is clearly "No." Let us take an illustration from the Restatement.<sup>34</sup> "B contracts with A to erect an expensive building on A's land. C's adjoining land would be enhanced in value by the performance of the contract. C is an incidental beneficiary." Such a beneficiary "acquires by virtue of the promise no right against the promisor or the promisee."<sup>35</sup> Whether we call him an "incidental beneficiary," or leave him nondescript, he gets no right under the contract, even though he would benefit by its performance.

Now suppose that a contract is made "for the benefit of a third party." That seems to say, not only that the third party would benefit, but also that the motive of the contractors was to procure that benefit for him. But motive is beside the point. Whether a contract has been made is not a question of motive. It is a question of agreement. Particularly it is a question of whether an alleged obligor consented to be bound. And, if so, to whom?

The motive of the contractors would be an impossible test as to whether the third party has a right against the promisor. To start on, the motive of the parties, if they had one, would be subjective and impossible to ascertain. And then, they have no joint motive. Each party to the bargain has his own motive for entering it. So far as the separate individual motives can be determined, they are varied. In a donee-beneficiary case the promisee usually has a motive to benefit the third party, but that is as far as motive can be followed as a clue. The motive of the promisor, even in a donee-beneficiary type of case, would normally be to get the price he received for his promise. In a creditor-beneficiary case the motive of the promisee would be, not to benefit the third party, but to get rid of his own debt; and the motive of the promisor would be, as before, to get the price for making his promise.

The fact that it is the agreement, rather than the motives of the contractors, that determines the right of the third party is neatly illustrated by the case of *Bailey v. New England Insurance Co*.<sup>36</sup> In that case it appeared that the defendant insurance company had promised to pay to the executors or administrators of the insured "For the benefit of his widow." After the death of the insured the widow brought suit on the policy. She

<sup>34</sup> § 133, Illustration 11.

<sup>35</sup> § 147

<sup>36</sup> 114 Mass. 177 (1873). See also *Campbell v. New England Ins. Co.*, 98 Mass. 381, 400 (1867).



was denied recovery. It was said by the court that the administrator, as trustee for the wife, could have maintained the action. It would seem that the widow could have joined the administrator and the insurance company by a bill in equity and so have realized on the policy. The point being emphasized at the moment is that the widow did not acquire a direct right against the company merely because the insured procured the policy "for the benefit of his widow." The company's direct obligation was to pay the administrator whom they bargained to pay.

### *Creditor-beneficiary's Right Against Promisee*

The procurement of a promise in favor of a creditor-beneficiary does not take away his claim against his debtor-promisee. But suppose the creditor-beneficiary asserts his right under the new promise that was procured in his favor. Does he thus give up his right against the promisee-debtor? To some courts it has seemed inconsistent for him to keep both rights. Such courts have held, accordingly, that the assertion of one of his rights is an election to give up the other.<sup>37</sup>

Such a result is not called for by either logic or justice. And, by an increasing number of decisions the creditor-beneficiary can hold onto both his rights until he gets what is coming to him.<sup>38</sup> As to the logic of the situation, the two rights are distinct. Each one stands on its own bottom. That is the respective rights were created by different sets of facts and usually at different times. It is true that the same performance—i.e., payment by either the promisor or the promisee, would satisfy both of the third party's rights. That, however, is consistent with the idea that two persons severally can be bound to bring about a given performance. It happens every time two persons execute a promissory note that binds them severally to pay an amount.

And, as to justice in such a situation, both rights are satisfied to the extent that either one of the obligors renders performance. The creditor-beneficiary gets no more than his due. He can get a judgment against either one or both of his debtors but he cannot, on such judgments, collect more than is coming to him.<sup>39</sup>

---

<sup>37</sup> *Bohanan v. Pope*, 42 Me. 93 (1856), *Warren v. Batchelder*, 16 N.H. 580 (1845), *Phenix Iron Foundry v. Lockwood*, 21 R.I. 556, 45 A. 546 (1900), *Wood v. Moriarty*, 15 R.I. 518, 9 A. 427 (1887).

<sup>38</sup> *United States v. Illinois Surety Co.*, 226 F. 653 (C.C.A. 7th, 1915), *affirmed* 244 U.S. 376, 37 S. Ct. 614, *Copeland v. Beard*, 217 Ala. 216, 115 So. 389 (1928), *Gay v. Blanchard*, 32 La. Ann. 497, 505 (1880), *Flint v. Winter Harbor Land Co.*, 89 Me. 420, 36 A. 634 (1896); *Lieberman, Loveman & O'Brien v. Bowden*, 121 Tenn. 496, 119 S.W. 64 (1908), *Restatement of Contracts* (1932) § 141(1).

<sup>39</sup> *RESTATEMENT CONTRACTS* § 141(1) (1932). *Erickson v. Grande Ronde Lbr. Co.*, 102 Or 556, 94 P.2d 139 (1939).

### *Third Party Contract Distinguished from Novation*

The minority view, to the effect that a creditor-beneficiary cannot retain both rights, may come from a notion that the transaction is like a novation.<sup>40</sup> A digression may be worth while to note the nature of a novation and to note wherein a novation differs from a typical contract in favor of a creditor-beneficiary. A simple novation can be illustrated like this: *B* owes *C*. A three party agreement is made among *A*, *B* and *C* whereby *A* undertakes to pay *C* and *C* gives up his claim against *B*. After such a transaction the one and only right of *C* is against *A*. The thing to note is that *C* gave up his claim against *B* as a part of the novation. But such a surrender of right is no part of a contract that is made in favor of a creditor-beneficiary.

### *Duties of Promisor*

It may be noted in passing that one who promises to pay a creditor-beneficiary comes under a duty to his promisee<sup>41</sup> and another duty to the creditor-beneficiary. Either one can recover substantial damages against the promisor if he omits to perform. But one performance—payment to the creditor-beneficiary will satisfy both of his duties.

### *Can the Parties Who Have Made a Contract Obligation that Runs to a Third Party Take It Away?*

When parties have made a contract that created nothing more than reciprocal rights between themselves they can rescind it. That is elementary. The rescission is simply a bargain wherein each party voluntarily gives up his right in exchange for the right that stood against him. But when a contract has been made that creates a right in a third party the contractors should not be able to take that right away. The third party's right is a species of property and should not be taken from him without his consent, even by the parties who created it. "It is plainly illogical," said Marshall, J.<sup>42</sup> "to hold that immediately upon the completion of the transaction between the immediate parties thereto, the law operates upon their acts and creates the element of privity between the promisor and the third person, and at the same time to hold that such person's status as regards the promise may be changed thereafter without his consent."

### *When the Right of Donee-beneficiary Becomes Vested*

There is some difference between the donee-beneficiary cases and the creditor-beneficiary cases as to when the third party's right becomes vested

<sup>40</sup> *Urquhart v. Brayton*, 12 R.L. 169 (1878).

<sup>41</sup> *In re Herbert & Co.*, 262 Fed. 682 (2d Cir. 1919), *Heins v. Byers*, 174 Minn. 350, 219 N.W. 287 (1928), *RESTATEMENT CONTRACTS* § 136 (1932).

<sup>42</sup> *Tweeddale v. Tweeddale*, 116 Wis. 517, 93 N.W. 440 (1903).

and beyond recall by the contractors. A donee-beneficiary's right is deemed to be vested at the moment the contractors complete the transaction even if the beneficiary has no notice of the contract. Said Hammond, J., in *Pruitt v. Pruitt*,<sup>43</sup> "It is well established law that when a gift is consummated it is irrevocable except by the consent of the donee." To be sure, the making of a contract for a donee-beneficiary is not technically a gift. It is not a transfer to the donee of something the donor had. It is the creation of a brand new obligation. It is like a gift, however, in that a right is created in the donee-beneficiary without cost to him. As in the case of gifts, acceptance would be presumed.

The inability of contractors to divest the rights of donee-beneficiaries is illustrated in many life insurance cases. The donee-beneficiary named in a life insurance policy acquires a vested right that cannot be taken away by the insured unless he reserved a power to do so.<sup>44</sup> And when a depositor in a building association takes a certificate of deposit payable to the depositor, or to a designated person, or the survivor, it amounts to a contract between the building association and the depositor for the benefit of the person designated and gives that person an immediate interest in the certificate of deposit.<sup>45</sup> *In re Di Santo's Estate*<sup>46</sup> grew out of a purchase by Di Santo of United States savings bonds. Each bond was payable to Di Santo or, in case of his death, to a named beneficiary. It was the opinion of the court "that each of the bonds in question evidences a contract between the United States of America and the registered owner for the benefit of a third person, the designated beneficiary." The court also noted that Mr. Di Santo "could not have changed a beneficiary prior to such beneficiary's death." The interest of the beneficiary became vested when Mr. Di Santo purchased each bond. And that was so although it was provided by a term in the bond that the beneficiary's right would expire if he should pre-decease Mr. Di Santo.

### *When the Right of a Creditor-beneficiary Becomes Secure*

By the weight of authority the right of a creditor-beneficiary does not become secure against the power of the contractors to undo it until the creditor-beneficiary knows about it and has, to some extent, relied on it.<sup>47</sup> It was noted above that the right of a donee-beneficiary vests and is secure at once, when a contract has been made in his favor. Why do courts hold

<sup>43</sup> 91 Ind. 595 (1883).

<sup>44</sup> *Perry v. Tweedy*, 128 Ga. 402, 57 S.E. 782 (1907), *Townsend v. Townsend*, 127 Ky. 230, 105 S.W. 937 (1907), *Haskell v. Equitable Life Assur. Soc.*, 181 Mass. 341, 63 N.E. 899 (1902).

<sup>45</sup> *Rhorbacker v. Citizens Building Association Co.*, 138 Ohio St. 273, 34 N.E.2d 751, 135 A.L.R. 988 (1941).

<sup>46</sup> 142 Ohio St. 223, 51 N.E.2d 639 (1943).

that the right of a donee-beneficiary is secure, but the right of a creditor-beneficiary is not secure, at the moment a contract has been made in favor of the one or the other? The courts do not often spell out the reason for this curious difference, but the reason is not far to seek.

The reason a creditor-beneficiary is not secure in his right, at the moment a contract has been made in his favor, stems from the subrogation, or asset, theory on which his right was for a long time supposed to depend. It was long deemed by a majority of the American courts that a third party's right, if he had any, was bottomed on two things. first, the third party's original right against the promisee, and, second, the promisee's right against the promisor on the new contract. On that basic theory the third party can recover against the promisor only if, and so long as, both of the aforesaid rights exist. We have noted one corollary of the subrogation theory—viz., a donee-beneficiary cannot recover. He has no right against the promisee. Now we come to this. A promisee can, of course, give up, by joining in a rescission, *his own right* against the promisor. That leaves the third party's case incomplete. The promisee's right—on which his case depended—is gone.<sup>48</sup>

To be sure, the subrogation theory has passed out of vogue. The theory on which a third party is allowed to recover has changed. We now simply hold promisors according to the tenor of their undertakings. But decisions that were made while the subrogation theory was in vogue set a pattern that continues to be law, after the reason for those decisions has broken down. Under the more modern and realistic explanation of third parties' rights, it is hard to see any reason why the right of a creditor-beneficiary should not be secure as soon as the contract in his favor has been made. The contractors have acted. The right they created for the creditor is like a gift or a contract for a donee-beneficiary in that it does not entail any cost or bring any burden to the party who gets it. The new promise (obligation) in favor of the creditor-beneficiary is offered to him as an added security that his

<sup>47</sup> Copeland v Beard, 217 Ala. 216, 115 So. 389 (1928), International Trust Co. v Keefe Mfg. & Inv. Co., 40 Colo. 440, 91 P. 915 (1907), Jones v Higgins, 80 Ky. 409 (1882), RESTATEMENT CONTRACTS § 143 (1932).

<sup>48</sup> In a case where a grantee had promised his grantor to pay a mortgage debt that was owing by the grantor, Wood, J., in his opinion writes as follows: "There is no privity of contract between the third party holding the mortgage lien or incumbrance. and, unless he has in some manner become a privy to the contract of sale, there is no reason why the parties to the contract may not rescind the same without his knowledge or consent. Under the equitable doctrine of subrogation, the mortgagee would only be entitled to such remedy as the debtor—the mortgagor or vendor himself—has against his vendee. If these immediate parties to the contract have rescinded the same before any privity has been established between the mortgagee or lienholder and the vendee who has assumed to pay the debt, then the mortgagee or lienholder has no right to complain. He must stand in the shoes of the mortgagor so far as the enforcement of any rights under the contract is concerned." McCown v Nicks, 171 Ark. 260, 284 S.W. 739 (1926).

claim against the promisee will be paid. Its acceptance by the creditor-beneficiary should be presumed, just as acceptance is presumed in cases of gifts and contracts made in favor of donee-beneficiaries.

When does the right of a creditor-beneficiary become secure? It is said in the Restatement of the Law Contracts<sup>49</sup> that the right of a creditor-beneficiary is defeasible "until the creditor brings suit, or otherwise materially changes his position in reliance on the promise." But it is not necessary that the creditor-beneficiary shall make out an estoppel in order to spike his right.<sup>50</sup> His acceptance of the right by giving notice is sufficient and the notice need not be formal.<sup>51</sup> Acceptance by the creditor-beneficiary is sufficiently evident when he receives payments from the promisor<sup>52</sup> or agrees to an extension of time<sup>53</sup> or institutes a suit against the promisor.<sup>54</sup>

### *Beneficiary Is Subject to Conditions*

We have noted that: the right of a donee-beneficiary is secure as soon as a contract has been made in his favor, and, that the right of a creditor-beneficiary is secure as soon as he acts on it to some extent. But the promisee's failure to meet conditions may take away the beneficiary's ability to recover. While an insured cannot take away the vested right of a designated beneficiary, he can omit to pay the premiums. Assuming that the company's liability is conditioned on such payments such an omission leaves the beneficiary without recourse. In *Di Santo's Estate*<sup>55</sup> it appeared that Mr. Di Santo had bought United States War Savings bonds payable, in case of his death, to named beneficiaries. The court said that "Mr. Di Santo could have cashed these bonds during his lifetime." Such non-cashing was therefore a condition precedent to the beneficiary's right. And in *Alexander H. Revell & Co. v. C. H. Morgan Grocery Co.*<sup>56</sup> it appeared that the promisee's omission to perform what he had agreed to do amounted to a failure of consideration. This prevented a creditor-beneficiary from recovering against the promisor.

<sup>49</sup> § 136 comment a.

<sup>50</sup> *Hill v. Hoeldtke*, 104 Tex. 594, 142 S.W. 871 (1912).

<sup>51</sup> *Jackman Cigar Mfg. Co. v. Berger & Son Co.*, 363 Ind. App. 437, 52 N.E.2d 363 (1944), *State Bank of New Salem v. Schultze*, 51 N.D. 66, 199 N.W. 138 (1924), *Zwietusch v. Becker*, 153 Wis. 213, 140 N.W. 1056 (1913).

<sup>52</sup> *Gifford v. Garrigan*, 117 N.Y. 257, 22 N.E. 756 (1889).

<sup>53</sup> *McGown v. Nicks*, 171 Ark. 260, 284 S.W. 739 (1926), *Hubard & Appleby, Inc. v. Thacker*, 132 Va. 33, 110 S.E. 263 (1922).

<sup>54</sup> *Johnson v. Armstrong*, 41 N.M. 206, 60 P.2d 992 (1937).

<sup>55</sup> 142 Oh. St. 223, 51 N.E.2d 639 (1943).

<sup>56</sup> 214 Ill. App. 526 (1919).